

SEC Overhauls the Framework Governing the Use of Derivatives by Regulated Funds

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*(Article from Registered Funds Alert, February 2021)**For more information, please visit the [Registered Funds Alert Resource Center](#).*

In a widely anticipated action that was years in the making, the SEC adopted Rule 18f-4 under the 1940 Act prior to the conclusion of former Chair Jay Clayton's tenure. The rule overhauls the regulatory framework for the use of derivatives and similar transactions by regulated funds, which for purposes of the rule includes registered closed-end funds, BDCs and registered open-end funds (including mutual funds and ETFs but excluding money market funds). Importantly, regulated funds can continue to follow the current asset segregation approach when investing in derivatives until the rule's compliance date of August 19, 2022 (the "Compliance Date").

The rule will replace the current asset segregation approach under which regulated funds enter into derivatives and similar transactions based on guidance in SEC Release 10666 and existing staff interpretations with a conditional exemption from the asset coverage requirements under Sections 18 and 61 of the 1940 Act. Regulated funds can voluntarily rely on the rule prior to the Compliance Date, and must rely on the rule following the Compliance Date in order to enter into derivatives and similar transactions without such transactions being subject to the asset coverage requirements under Sections 18 and 61 of the 1940 Act.

This Alert provides an overview of key attributes of the rule. This article then revisits issues that were raised in our prior [Alert](#) relating to the proposed rule and examines the changes that were made to the final rule to address those concerns. For background on existing interpretive guidance regarding the use of derivatives and similar transactions by regulated funds, please see our prior [Alert](#). For those who may be wondering, the derivatives rule does fall within the look-back period under the Congressional Review Act that would allow the new Democratic-controlled Congress to overturn the rule, but we do not expect that will occur.

Overview of the Key Attributes of the Rule

In the adopting release, the SEC reiterated its view that all derivatives and similar transactions that create future payment obligations fall within the functional meaning of the term "evidence of indebtedness" and therefore involve the issuance of a senior security for purposes of Section 18 of the 1940 Act. Under the rule, a "derivatives transaction" includes any swap, security-based swap, futures contract, forward

contract, option, any combination of the foregoing, short sale borrowings, or any similar instrument (such as to-be-announced investments (“TBAs”) or dollar rolls, in either case with a maturity of more than 35 days). In addition, a regulated fund may choose to treat reverse repurchase agreements or similar financing transactions as derivatives transactions for purposes of the rule (which is a change from the proposal, which would have required funds to treat reverse repurchase agreements as borrowings).

The most significant attributes of the rule and related requirements include:

1. **Derivatives Risk Management Program**. All regulated funds that do not qualify as “Limited Derivatives Users” (discussed below) must adopt and implement a written derivatives risk management program, which is administered by a derivatives risk manager (“DRM”). The DRM will be designated by the regulated fund’s board, must have relevant experience regarding the management of derivatives risk and may not be a portfolio manager of the regulated fund (or, if the DRM is a group, the majority of the group cannot be composed of portfolio managers). The program must address the following elements, as detailed in the rule: (1) risk identification and assessment; (2) risk guidelines that provide for quantitative and measurable criteria; (3) stress testing to evaluate potential losses to a Regulated Fund’s portfolio under stress conditions; (4) backtesting of the VaR calculation model that the regulated fund uses each business day; (5) internal reporting and escalation of certain derivative matters to the fund’s portfolio management and board; and (6) a periodic review of the program, at least annually, to evaluate the program’s effectiveness.
2. **VaR Limit on Fund Leverage Risk**. Regulated funds that are not Limited Derivatives Users must comply with a relative VaR test based on either a designated reference index or the regulated fund’s securities portfolio (collectively, the “designated reference portfolio”), or, if the DRM reasonably determines in accordance with the rule that the relative VaR test is not appropriate, an absolute VaR test based on the value of the regulated fund’s net assets.
 - A regulated fund must determine its compliance with the applicable VaR test at least once each business day and must come back into compliance promptly after a determination of non-compliance. If a regulated fund is not in compliance with the applicable VaR test within five business days, there are additional board reporting requirements and a requirement to report confidentially to the SEC on Form N-RN.
 - Under the relative VaR test, a regulated fund’s VaR must not exceed 200% of the VaR of the regulated fund’s designated reference portfolio. For closed-end funds and BDCs that have outstanding preferred stock, this limit is increased to 250%.
 - Under the absolute VaR test, a regulated fund’s VaR cannot exceed 20% of the value of the regulated fund’s net assets. For closed-end funds and BDCs that have outstanding preferred stock, this limit is increased to 25%.
 - The VaR test must (i) take into account and incorporate all significant, identifiable market risk factors associated with a fund’s investments, (ii) use a 99% confidence level and a time horizon of 20 trading days and (iii) be based on at least three years of historical data. When calculating the 99% confidence level, the SEC confirmed in the adopting release that a regulated fund may rescale a calculation initially performed at a 95% confidence level.

The changes to the VaR test and related guidance in the release more closely align the rule’s VaR test with the UCITS Guidelines familiar to global asset managers, which were proven to be effective during the market turbulence at the onset of the COVID-19 pandemic.

3. **Reverse Repurchase Agreements**. A regulated fund is permitted to treat reverse repurchase agreements or similar financing transactions as derivatives transactions for purposes of the rule. Similar financing transactions include tender offer bond (“TOB”) financings, the investment of securities lending collateral in securities and the purchase of a security on margin, but do not include TBAs or the investment of securities lending collateral in cash or cash equivalents.

Alternatively, a regulated fund may choose to treat a reverse repurchase agreement or similar financing transaction as indebtedness subject to the asset coverage requirements of Section 18 of the 1940 Act. A fund’s election will apply to all reverse

repurchase agreements or similar financing transactions so that all such transactions are subject to consistent treatment under the rule.

4. **Unfunded Commitment Agreements.** A regulated fund may enter into unfunded commitment agreements if it reasonably believes, at the time it enters into such an agreement, that it will have sufficient cash and cash equivalents to meet its obligations with respect to all of its unfunded commitment agreements, in each case as they come due.^[1] In forming the required reasonable belief, a fund may take into account the issuance of debt (*e.g.*, borrowings under a credit facility). This standard is similar to the one that the SEC staff has been requesting registrants adhere to in comment letters related to registration statements for the past several years. However, a regulated fund must take into account its reasonable expectations with respect to other obligations, and may not take into account cash that may become available from the sale or disposition of any investment at a price that deviates significantly from the market value of those investments, or from issuing additional equity.

A regulated fund must document the basis for its reasonable belief at the time it enters into each unfunded commitment and must maintain such record for at least five years following the date of the agreement. For some regulated funds, this may require a change to current recordkeeping practices. Any regulated fund that historically has not maintained such records will need to develop compliance procedures to ensure it is compliant with the conditions of the rule by the Compliance Date.

5. **Delayed Settlement Cycle Securities.** The rule provides a conditional exemption from the requirements of Sections 18 and 61 for regulated funds that invest in a security with a delayed settlement cycle (including when-issued and forward-settling transactions such as TBAs and dollar rolls), provided that the fund intends to physically settle the transaction and the transaction will settle within 35 days of its trade date.
6. **Board Oversight and Reporting.** On or before the implementation of the derivatives risk management program, and at least annually thereafter, the DRM must provide the regulated fund's board with a written report representing that the derivatives risk management program is reasonably designed to manage the regulated fund's derivatives risks and related information required by the rule. The DRM must also provide periodic written reports to the board. The board is responsible for designating the DRM.
7. **Limited Derivatives Users Exception.** Limited Derivatives Users are not required to adopt a derivatives risk management program, comply with the VaR limit on fund leverage risk or comply with the board oversight and reporting requirements. To qualify as a Limited Derivatives User, a regulated fund's derivatives exposure (as defined under the rule, which is gross notional exposure for most types of derivatives) cannot exceed 10% of its net assets, excluding certain currency or interest rate derivatives used for hedging purposes in accordance with specific requirements set out in the rule. Limited Derivatives Users are required, however, to adopt and implement written policies and procedures reasonably designed to manage the regulated fund's derivatives risk. If a regulated fund exceeds the 10% derivatives exposure threshold and does not reduce its exposure within five business days, the regulated fund's adviser must provide a written report to the fund's board informing it whether the adviser intends to reduce the exposure promptly, but within no more than 30 days, or put in place a derivatives risk management program and comply with the VaR-based limit on fund leverage risk as soon as reasonably practicable.

The rulemaking also included new recordkeeping requirements; amended Form N-CEN, Form N-PORT and Form N-LIQUID (renamed Form N-RN) to enhance disclosures regarding the use of derivatives and compliance with the rule; and amended Rule 6c-11 under the 1940 Act to allow leveraged and inverse ETFs to operate without the need for exemptive relief. The SEC did not adopt the proposed sales practice rules related to leveraged and inverse ETFs.

On the Compliance Date, current SEC interpretive guidance in Release 10666 will be rescinded and staff no-action letters and other guidance addressing derivatives and other transactions covered by the rule will be withdrawn.

Issues We Wanted Reconsidered and the Result in the Final Rule

As we noted in our prior Alert on this topic, we advocated for the changes set out in italics below, which we thought would improve the rule. Many of these changes were incorporated into the final rule.

The DRM should be able to choose which VaR test to comply with regardless of its ability to identify an appropriate “designated reference index.”

The final rule partially addresses this concern. The proposed rule required regulated funds to use the relative VaR test unless they were “unable to identify” a designated reference index, which created uncertainty regarding the amount of diligence a DRM was expected to undertake in considering potential indices. While the final rule still states that the relative VaR test is the “default” test, a regulated fund can use the absolute VaR test if the DRM reasonably determines that a designated reference portfolio would not provide an appropriate reference portfolio for purposes of the relative VaR test, taking into account the fund’s investments, investment objectives and strategy.

The reasonableness standard in the final rule provides the DRM with much-needed flexibility in being able to determine which VaR test would be most appropriate for the regulated fund. This standard also more clearly states what is expected of the DRM in making this determination.

The proposed leverage limits should be increased to a 200% relative VaR limit and a 20% absolute VaR limit.

This suggested change was incorporated directly into the final rule, and many in the industry provided a similar suggestion. These limits are in line with the UCITS Guidelines, which global asset managers have operated under for many years, including during the current COVID-19 crisis. Such an approach allows global asset managers to streamline their risk management programs in a manner that has proven effective during the current market crisis and can be useful in future market crises.

Related to VaR testing, we also suggested that the final rule allow a DRM to choose a 95% confidence level in order to obtain additional observations to produce a more robust and stable measure of risk, the results of which could then be rescaled to a 99% confidence level equivalent. In the adopting release, the SEC provides interpretive guidance confirming that the 99% confidence level required by the rule may be calculated in this manner.

The “limited derivatives user” definition in the proposed rule should be revised to modify the 10% derivatives exposure limit to allow for currency and interest rate hedging in addition to such limit.

This suggestion was incorporated into the final rule. The proposed rule required that Limited Derivatives Users fall into one of two categories: (1) those that limit their overall use of derivatives to 10% of their net assets with certain limited adjustments *or* (2) those that exclusively use derivatives for currency hedging. At the urging of commenters, the final rule permits regulated funds to exclude certain currency and interest rate hedging transactions from the 10% threshold, essentially combining the two bases in the proposed rule into one objective standard for Limited Derivatives Users in the final rule.

Reverse repurchase agreements are not analogous to bank borrowings and should not be subject to the 300% asset coverage requirement.

This proposed change was addressed in the final rule. The rule gives regulated funds the choice in determining if they want to treat reverse

repurchase agreements as borrowings or as derivatives transactions. This approach provides a regulated fund flexibility to choose an approach that is best suited to the fund’s investment strategy and/or operational needs, while still addressing the asset sufficiency and leverage concerns in Section 18.

During the 18-month compliance period, regulated funds should evaluate the two options described above and decide which is the best method for a particular regulated fund to use going forward. Regulated funds should consider that the election will apply to all reverse repurchase agreements and similar financing transactions.

General Reception of the Rule as Adopted

The final rule has generally been received positively, particularly with respect to certain changes in the final rule that address many of the concerns raised during the comment process. Notwithstanding these developments, certain individuals at the SEC have publicly raised concerns about the rule as adopted. Most of these concerns relate to the omission of proposed sales practice rules for leveraged and inverse ETFs that are unrelated to the rule’s substantive regulation of the use of derivatives and similar transactions by regulated funds and outside the scope of this article.

Specifically, Commissioner Lee [expressed disappointment](#) that the final rule did not include the sales practice rules that were designed to address investor harms arising from unsuitable purchases and sales of leveraged and inverse ETFs, which she says is to the detriment of retail investors. Commissioner Crenshaw also [echoed these concerns](#) related to the sales practice rules, and further stated that the final rule “failed to address the significant risk that derivatives can pose to funds and investors.” Commissioner Crenshaw cited to evidence suggesting that retail investors buy leveraged and inverse fund products without truly understanding their features, which can lead to significant losses, and believes the rule as adopted does nothing to address this problem.

While the concerns raised by Commissioners Lee and Crenshaw could be addressed by the SEC in subsequent rulemaking or interpretive guidance, we believe the SEC is unlikely to revisit the final set of rules that were adopted. Given the SEC’s current set of policy priorities, however, and the disappointment expressed by the Democratic Commissioners regarding the absence of a sales practice rule, we would not be surprised if the SEC chose to make the adoption of a sales practice rule a priority during the new administration’s term.

What’s Next

The SEC has provided for an 18-month transition period for regulated funds to comply with the rule and related reporting requirements. Regulated funds must be in compliance with the rule by August 19, 2022.

[1] Many industry leaders commented on the potentially problematic treatment of unfunded commitments in the initial derivatives rule proposal in 2015. In response to those comments, the reasonable belief standard was included in the 2019 re-proposal and adopted in the final rule. We suggested a similar standard in our 2016 [comment letter](#) to the SEC on the initial proposal.

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